No. 11881

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

MARLBOROUGH CORPORATION,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANT'S REPLY BRIEF.

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If the trial court had actually found the facts which appellee says it *could* have found, this appeal would never have been taken. The cold fact is that most of the findings which appellee imputes to the District Court are those which appellee desired and urged upon the Court, but which it declined to adopt.

At the trial appellee urged the Court to find that taxpayer's earnings were accumulated beyond the reasonable needs of its business [R. 21]. The Court did not so find, even though the statute[1] makes this test a crucial one in such cases.

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[1]Section 102(c) I. R. C. and Revenue Act of 1938.

Appellee asserts that the Court affirmatively found that taxpayer was availed of for the purpose of avoiding surtaxes on its shareholder, implying that the Court's finding was based upon direct evidence of such purpose (Brief, pp, 3, 6). The Court did no such thing, for if it had, it would have been entirely unnecessary for the Court to have bottomed its conclusion upon so-called holding company status, or upon the conclusion that appellant had not proved that there was no purpose to avoid surtaxes [R. 29].

Appellee repeatedly suggests that the District Court's findings were the result of its disbelief of the principal witness, Eugene Overton (Brief, p. 24 *et seq.*). The record and particularly the Court's findings are bare of any indication that it found any of the testimony incredible.

It would unduly burden this brief, to no useful purpose, to haggle over all the many inferences which appellee urges this Court to assume that the trial court drew from the evidence. To show that the trial court would have repudiated their authorship, we shall expose the fallacies in the more important inferences which appellee would have this Court attribute to the District Court.

I.

Substantiality of Evidence Supporting the Finding of Purpose to Avoid Surtaxes.

Referring to evidence that appellant was engaged in renting school property; that it had earnings and surplus at the end of each of the taxable years involved; that it owned securities; that it distributed only part of its earnings as dividends; that its stock was closely held; that its stockholders had income independent of that of their corporation; that the stockholders realized that the receipt of dividends would cause them to pay surtaxes; and that the stockholders did not have to pay surtaxes upon the earnings not distributed as dividends, appellee asserts that these facts are typical of cases in which the section 102 surtax has been imposed, citing cases.

As pointed out in our opening brief (p. 40) the facts to which appellee gives such significance do no more than establish the financial climate within which the interdicted purpose *could* exist. They are of no substance in establishing that such purpose *did* exist.

They are, as appellee says (Brief p. 8), "typical," but they are typical of any one of thousands of corporations against which there has never been a penny of section 102 surtax asserted. They are not typical of the situations in the cases cited by appellee. In those cases not only was the financial atmosphere present, but there were other factors present which established the existence of the purpose as distinguished from the bare possibility of its existence.

In the cited cases:

(1) The Courts found earnings to have been accumulated beyond the reasonable needs of the business. *Helvering v. National Grocery Co.*, 304 U. S. 282, 285; *Helvering v. Chicago Stockyards Co.*, 318 U. S. 693, 697; *Wilson Bros. & Co. v. C. I. R.*, 124 F. (2d) 606, 609; *Trico Products Corp.*, 137 F. (2d) 424, 426; *McCutchin Drilling Co. v. C. I. R.*, 143 F. (2d) 480, 482.

(2) The Courts found that loans were regularly made to the stockholders for their personal use. *National Grocery Co., supra; Chicago Stockyards Co.*, in the Board of Tax Appeals, 41 B. T. A. 590, 622; *Wilson Bros. & Co., supra; McCutchin Drilling Co., supra.*

(3) The Courts found that the stockholder transferred profit-yielding assets to the corporation to escape the personal taxes thereon and to produce deductible losses in their personal returns. *Chicago Stockyards Co., supra,* Board of Tax Appeals opinion, 41 B. T. A. at 622; *R. L. Blaffer & Co.*, 103 F. (2d) 487, 488; *Wilson Bros. & Co., supra; Semagraph Co. v. C. I. R.*, 152 F. (2d) 62, 64; and in *McCutchin Drilling Co., supra,* the Court found that the corporation's funds were used to finance drilling operations conducted and purchases made by the stockholder (Opinion, p. 482).

(4) The Courts found in many cases that no dividends at all had been paid. *Semagraph Co., supra,* p. 64; *R. L. Blaffer & Co., supra,* p. 488; *Wilson Bros. & Co., supra,* p. 608; *McCutchin Drilling Co., supra,* p. 482; *National Grocery Co., supra,* p. 294.

(5) The Courts found that investments in securities were beyond the need for any "conceivable expansion"

(*National Grocery Co., supra,* p. 294); that the securities owned had been transferred to the corporation to escape tax on the dividends therefrom (*Chicago Stockyards Co., supra,* Board of Tax Appeals, opinion, p. 622); that the securities held by the corporation were moved in and out of the corporation at will and for the purpose of establishing loss deductions on the shareholders' personal returns (*R. L. Blaffer & Co., supra,* p. 488); that the securities were purchased by the corporation with funds "contributed" by the stockholders in order to transfer the earnings therefrom from their personal returns to the corporation (*Wilson Bros. & Co., supra,* p. 608).

All of these activities were "typical" of the cases cited by appellee, but not a single one of them is typical of the activities carried on by appellant (See Opening Brief, pp. 22-28).

In none of the cases cited by appellee were the securities owned by the corporation earmarked to cover sustained depreciation and known needs, as was the case here (See Opening Brief, pp. 25-28). Appellee says these needs, as testified to by Overton, were "remote and speculative," "obviously untrue," "mere blinds," (Brief, p. 6), "too patently unreasonable to be worthy of belief" (Brief 19).[2] The District Court did not think so, because though such a finding was put in issue and requested by appellee [R. 4, 9, 13, 14, 21, 124], the Court did not find the ownership of the securities, for the purposes here in evidence, beyond the needs of the business. If the Court below

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[2]In passing, it may be noted that these are serious accusations. Appellee accuses Overton, a man of high professional and civic standing in the community for many years, of perjury.

found anyone's contentions incredible, therefore, they were appellee's, not appellant's.

Typical also of the inferences which appellee says must be imputed to the trial court (and of which it declined authorship) is the one on page 12 of appellee's brief in which it attacks the reasonableness of Overton's provision for possible fire losses. The simple addition of $190,765 ordinary insurance and the $119,000 contingency insurance, and the deduction of the replacement cost of the main frame building, $255,188, does not render the provision of $20,000 for uninsured fire losses illusory.

In the first place, the ordinary insurance was 90% co-insurance [R. 39]. Obviously if the insurer was obligated to indemnify the taxpayer to the extent of $190,765, then taxpayer had to be prepared to bear 10% of that amount, or $19,076.50, which is the $20,000 provided for that purpose. The contingent insurance covered only the *excess* of current costs over original costs, not the total of original costs [R. 39].

Secondly, appellee ignores the fact that the $20,000, so provided, was to cover not only actual property loss, but also the necessary incidents thereof such as refunding of tuition, paying teachers who were under contract, and such items [R. 40].

Another inference urged by appellee, which the trial court declined to father, was that set forth in appellee's brief, pages 15-16, wherein it attacks the provision setting aside liquid assets for the purpose of funding accumulated depreciation. As it has done throughout the history of this case, appellee insists on treating depreciation reserves ($180,582.31 at the end of 1940) as if they were assets which could be used to meet business needs. A

depreciation reserve is *not* an asset. It is a credit item in a balance sheet which simply reflects, in terms of dollars, the loss of useful value of a depreciable asset based on its original cost. Not a single board, nail, or stick of furniture can be bought with depreciation reserves. What such reserves do signify, as appellant urged and the lower court understood, is that a specific portion of the cash and securities on the asset side of the balance sheet represents a recovery, over the years, of the sums originally expended to acquire the depreciable property used in the business (See Opening Brief, p. 26). So, we should be talking about reserved assets, not depreciation reserves. The $67,000 and $75,000 amounts set aside in liquid assets as a replacement fund to cover accumulated depreciation were not only clearly inadequate for that purpose [R. 43, 44] but if used for some other purpose would become even more inadequate. Moreover, a remaining life of seven to ten years (See Appellee's Brief, p. 15) provides very little time to make up an asset-deficiency of the difference between $75,000 and $255,188 [R. 166], the cost of replacing the main frame building.

Nor does the fact that the properties were in "good repair" in *1946* (after the repairs and remodeling expenses incurred by the corporation upon resuming possession of the school) [R. 205-221] imply that their useful lives had been extended by a day. No one should know better than appellee's counsel that the Bureau of Internal Revenue classifies repair expense as expense which preserves but does not restore the useful life of the property.

The reference to the state of good repair which the Court made in its findings has significance only in that it corroborates the testimony of appellant's witness that ex-

traordinary repairs to the properties were anticipated in 1939 and 1940 [R. 82, 103, 179]. It does not signify that the main building, then some 30 years old, had sustained no substantial depreciation. The trial court did not find these provisions unreasonable, and there is no justification for appellee's suggested inference that they were.

Appellee's attitude regarding the $35,000 owed the Overtons has a peculiar inconsistency which shows why the trial court thought the existence of this loan did not imply what appellee says it did. On pages 12 and 13 of its brief, appellee says that the funds set aside to pay the debt to the Overtons were available for fire loss contingencies. On pages 16 and 17 of its brief, appellee argues that the corporation could have paid these debts at any time. Now clearly if the funds were used to pay the debts, they would not be available to meet contingencies. Appellee should ride horses going in the same direction.

Appellee argues (Brief, p. 16) that the earmarking of $35,000 to pay the debts to the Overtons is not entitled to consideration because they could have been paid off at any time. This is the type of prestidigitation which appellee considers sound financial policy. The trial court could see, if appellee could not, that if the assets earmarked for the payment of the debts were distributed as dividends, they would not be available to pay the debts.

We presume appellee would suggest that the dividend money could then be loaned back to the corporation to be used to pay off the Overton debts, since that is what ap-

pellee suggests could be done with assets set aside for other purposes. That sounds foolish? Well, it's appellee's idea of an inference which the District Court could have drawn.

On page 27 of its brief, arguing the lack of necessity for accumulating earnings for its business needs, appellee says that "the trial court could have considered that a family corporation such as this could have been equally well protected against contingencies by distributing the earnings and having its stockholders rather than the corporation invest them in securities."

How the trial court must have savored the prospect of drawing the brilliant deduction that the way for a corporation to provide for its business obligations and needs is to distribute its liquid assets as dividends so that it will be forced to increase its obligations by borrowing those assets back! Clearly, in declining to find these provisions for the needs of the business unreasonable, the trial court showed that it would not be a party to so foolish an inference.

Curiously, while appellee says this is what appellant should have done with regard to dividends, it takes precisely the opposite view with respect to the interest paid the Overtons on their loans (Brief, p. 17). Both dividends and interest bear personal surtaxes. If dividends could be loaned back to strengthen the corporation's finances, why was the payment of interest any different? If the corporation had *not* paid interest on the loans, appellee would

be arguing that this was done to avoid surtaxes on the interest to which the Overtons were entitled.

The fact that the corporation pursued ordinary everyday business practices in *both* respects apparently has a sinister aspect to appellee that the trial court did not appreciate, for it found nothing unreasonable in the loans which the Overtons had made years before to help pay the cost of the original buildings [R. 55-58].

Appellee also urges that the satisfaction of a moral obligation to Mrs. Overton's deceased mother has sinister implications. We need say no more than what the trial court said in pursuing the point during Overton's examination.

> "The Court: In other words, if that was the provision of the will or whatever the estate provision was relative to that bequest, the assets were burdened with it? A. Morally burdened with it." [R. 189.]

Perhaps it is too much to expect the Government to understand a moral burden, but ordinary people, unfortunately, have to live with their moral burdens.

Appellee insists (Brief, p. 20) that appellant was a "family pocketbook." But the circumstances to which that term has been applied in the cases cited by appellee are absent here. There were no "wash sales" or sales to the corporation by the stockholders to effect deductible personal losses, as was the case in *R. L. Blaffer & Co., supra.*

There were no transactions whereby the stockholders here bought from and sold to the corporation; nor did they transfer their *own* securities to the corporation so as to shift the income thereof to the corporation; nor did they transfer large amounts of personal funds to the corporation each year without interest; there was no holding of the corporation's assets in the stockholders' names; nor was appellant *formed* to act as a holding company, all of which were present in *Rands, Inc. v. C. I. R.,* 34 B. T. A. 1094, cited by appellee.

Nor was appellant simply a corporate device to contract for and receive compensation for the personal services of a highly paid cartoonist; nor were most of the stockholders' income-producing assets transferred to the corporation; nor did the corporation purchase personal residences for the stockholders to live in; nor did the corporation pay for life insurance on the stockholder's life, all of which circumstances were considered significant in *Reynard Corporation v. C. I. R.,* 37 B. T. A. 552, cited by appellee.

In the instant case there was a complete absence of transfers of assets between the appellant and its stockholders, except for the loan to appellant in 1925 to refinance the loan made from Mortgage Guarantee Company, the five day loan of $1,000 to Mrs. Overton in 1932; and the payment of dividends and interest to the stockholders. If appellant was a "corporate pocketbook," its hinges were pretty rusty.

II.

Appellant's Status as a Mere Holding or Investment Company.

The trial court found:

> "During the two taxable years in question, plaintiff conducted no substantial activities other than the *management* of its investments and the receiving of rentals from the lessee of the school properties. The taxes upon the school properties were paid by the lessee under the terms of the lease. This lease also provided for certain *consultations* between plaintiff and the school operator." [R. 28.] (Emphasis ours.)

The regulations cited by appellee (Brief p. 21) refer to a holding company as one which has "practically no activities except holding property, and collecting the income therefrom or investing therein." An investment company is one which invests in properties not only for the income yield but also for the profits from market fluctuations.

Now admittedly appellant did the thing described in the regulations. But the *management* of appellant's investment in the Marlborough School, including the "consultations" provided for in the lease, goes considerably farther than the mere holding of property.

Appellant has no quarrel with the trial court's finding, quoted above. The precise point is that the use, by the Court, of the terms "management" and "consultations" discloses a realization by the Court that appellant's activities constituted something substantially more than the passive holding of property and the receipt of rentals. It is the legal conclusion [R. 28] to which exception is taken.

Two questions are raised by the Court's Conclusion No. I.

First, the Court concluded as a matter of law that appellant was a "holding company" but it did not conclude that it was a "mere holding company." Upon this distinction of the *prima facie* evidence depends. The law gives rise to *prima facie* evidence only if the corporation is a mere holding company—not if it engages, among other things, in holding properties. *Olin Corp. v. C. I. R.,* 42 B. T. A. 1203, 1214.

Second, the finding that appellant engaged in management activities with respect to the school properties and business precludes, in itself, a legal conclusion that appellant was merely holding its properties in the passive sense used in the statute and regulations.

Appellee attempts to brush off the holding of the Supreme Court in the *Higgins v. Commissioner*[3] case by saying that the circumstances there did not involve the instant statute.

We agree, that case did not involve section 102; but it did involve the question whether, for federal tax purposes, the renting and management of real estate constitute the mere holding of investments, or the carrying on of an active business. The Supreme Court held that the latter was the case and permitted the deduction of expenses which would not have been deductible except for the reason that they were incurred in carrying on a trade or business.

Third, the supervisory powers specified in the lease [R. 199, 248] and reserved to protect the participation of appellant in the profits from the operation of the school give added force to the proposition that the term "management" as used by the District Court in its findings meant something more than "mere" holding or investing.

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[3]312 U. S. 212.

III.

Holding or Investment Company Status as Prima Facie Evidence.

Appellee's brief, page 23, discloses that it misperceives appellant's argument. Appellant does not contend that the *fact* of holding company status, if it existed, disappeared upon the introduction of contrary evidence, but that its effect as *prima facie* evidence (*i.e.,* the inference which is compelled in the absence of contrary evidence) disappears.

The Supreme Court in *Webre Steib Co. v. C. I. R.,* 327 U. S. 164, at 171, stated that upon the introduction of contrary evidence the "presumption" derived from the fact, not the fact itself, disappears and the case is to be decided as if there "had never been any presumption."

The fact itself remains, but the inference of purpose is no longer compelled. At this point it becomes evidence which would permit the inference of purpose, unless such an inference would be clearly unreasonable and erroneous. Cf. *Wigmore on Evidence* (1940), Vol. IX, §2494. It was appellant's purpose, in citing the cases and opinion of Judge Campbell, on page 29 of its Opening Brief, to point out that on this record the evidence introduced by appellant by way of testimony, exhibits and stipulations, was so clear, full, uncontradicted and unextraordinary that the trial court erred in finding that appellant had failed to sustain its burden of proof even if taxpayer was a holding company.

The point is that once contrary evidence is introduced and the effect of a fact as *prima facie* evidence disappears, it is just ordinary evidence, to be considered with other evidence bearing upon the ultimate question. To thereafter give it the effect of compelling the inference appellee desires would be error, because under the law it no longer has that effect.

We do not interpret the Court's decision in *J. M. Perry & Co. v. C. I. R.,* 120 F. (2d) 123, as holding that after the fact loses its effect as *prima facie* evidence it nevertheless compels the inference which would follow if no contrary evidence had been introduced. To do so would throw the decision in the *Perry* case into conflict with the authorities cited above, including the Supreme Court. We interpret that decision as holding that on the record in that case the evidence showing unreasonable accumulations, loans to stockholders and others, the building of residential buildings, and sales transactions with its stockholders were affirmative evidence of the existence of the proscribed purpose.

The nub of this particular issue in the instant case is that the trial court did give the fact of holding company status the *compelling* effect which the authorities say it does not have.

IV.

Absence of Any Finding That Appellant's Earnings Were Unreasonably Accumulated.

While the trial court was not required to find whether appellant's earnings were accumulated beyond the reasonable needs of its business, its unwillingness to do so in the instant case has particular significance.

Aside from the fact that the statute makes this fact an important test in such a case, the fact was put in issue by the pleadings and in the Joint Pre-Trial Memorandum [R. 21]. The testimony from end to end was directed largely toward the exploration of this question. It was the most important question in the briefs of the parties below, and appellee's brief shows the extent to which the Government still relies upon its view of this question.

In spite of all this, the Court after reviewing the testimony, particularly that of Morgan Adams and Thompson Webb, declined, though vigorously urged by appellee, to find these accumulations unreasonable.

Naturally appellee wishes to deprive appellant of the evidentiary value of the fact that its provisions for the obligations and needs of its business were regarded as reasonable by the trial court. But does it stand to reason that where so important and so warmly contested an issue consumed the bulk of the time and record in this case the trial court would have registered its determination by saying nothing?

If the Court had thought the provisions made by appellant for its business needs unreasonable, would it not have been grossly derelict in its duty to have failed to find such to have been the fact?

The bald fact is that as regards the matter of the accumulation of liquid assets for the purposes testified to by appellant's witnesses, the Court agreed with those witnesses; and appellee's efforts to persuade this Court that the District Court *could* have found otherwise and that it found the testimony of those witnesses incredible is pure wishful thinking on appellee's part.

Surely this Court is not going to agree with appellee that the trial court committed so naive and Brobdingnagian a boner as that.

It is not necessary to compute the sum of two plus two by differential calculus. While, in order for it to be a *fact of record,* the trial court was required to find appellant's accumulations unreasonable, the simple significance of the Court's not finding that fact is that it found them reasonable. Or if we simply say that the trial court did not find appellant's financial policies unreasonable, that alone fortifies the good faith with which they were pursued.

Conclusion.

It must be apparent that the many inferences attributed by appellee to the trial court are neither those which that Court would have espoused nor are they inferences which reasonable men would draw from the evidence.

It is clear that due to small but important errors in construing the law the trial court:

1. Concluded that appellant was a holding company under the law.

2. Concluded that that fact established a *prima facie* case for appellee.

3. Concluded that appellant had not produced evidence sufficient to overcome the *prima facie* effect of holding company status, and had therefore not proved its case.

Rule 52(a) does not operate to entrench with finality the conclusions drawn by the trial court from its findings. *Kuhn v. Princess Lida of Thur & Taxis,* 119 F. (2d) 704; *Bach v. Friden Calculating Machine Co.,* 155 F. (2d) 361.

Respectfully submitted,

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